

## Management's Discussion and Analysis

This analysis, prepared by the Office of the Comptroller, offers readers of the Commonwealth's financial statements a narrative overview of the activities of the Commonwealth for the fiscal year ended June 30, 2005 (FY05). We encourage readers to consider this information in conjunction with the additional information that is furnished in the letter of transmittal, which can be found preceding this narrative, and with the Commonwealth's financial statements, which follow. This analysis is required by the Governmental Accounting Standards Board (GASB) which provides preparers with guidelines on what must be included and excluded from this analysis. All amounts, unless otherwise indicated, are expressed in thousands of dollars.

### Financial Highlights – Primary Commonwealth Government

#### *Government–Wide Highlights*

- ♦ **Net Assets** – The liabilities of the Commonwealth exceeded its assets at the end of FY05 by over \$8.5 billion. Of this amount, “unrestricted net assets” is reported as a negative \$14.6 billion. The primary reason for negative unrestricted net assets is that the Commonwealth is incurring long-term obligations to either construct or assist political subdivisions in constructing assets owned by these political subdivisions. For example, upon completion, the Central Artery / Third Harbor Tunnel will be owned by the Massachusetts Turnpike Authority and the Massachusetts Port Authority. The Commonwealth, however, is paying for the construction of these assets and retains \$5.4 billion of related debt. Similarly, the Commonwealth has a liability of \$8.7 billion for its share of the construction costs of schools owned and operated by municipalities. In FY05, new legislation changed the funding of school construction from direct appropriations to a dedicated portion of the sales tax administered by the new Massachusetts School Building Authority (MSBA), a “blended” component unit of the Commonwealth. Also, the authority's enabling legislation obligated the authority for projects that had previously been on a waiting list. This change caused an increase in the liability for school construction from \$3.6 billion in FY04 to \$8.7 billion in FY05. Finally, significant restricted net asset balances were set aside for unemployment benefits and debt retirement.

#### *Fund Highlights*

- ♦ **Changes in Net Assets** – The Commonwealth's net assets decreased by over \$4.6 billion in FY05. Net assets of governmental activities decreased by the majority of this \$4.6 billion, incurring a \$5.2 billion deficit during the fiscal year. The decrease in net assets is primarily attributable to the aforementioned school construction activity. However, this was somewhat offset by an increase in tax revenues by nearly \$1.2 billion above prior year collections. Net assets of the business – type activities showed an increase of nearly \$561 million. Expenses of governmental activities were nearly \$39.5 billion. General revenue for the Commonwealth, net of transfers, but including taxes, investment income and tobacco settlement income from governmental activities was over \$18.7 billion.

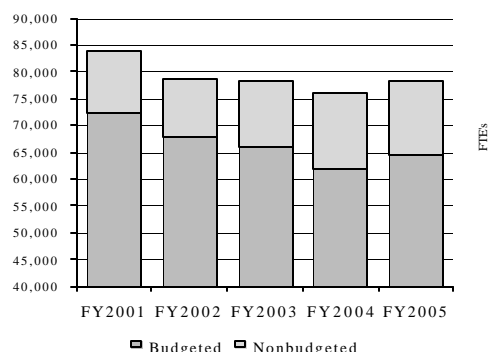
◆ **Governmental Funds – Fund Balances** – As of the close of FY05, the Commonwealth’s governmental funds reported a combined ending fund balance of over \$5.0 billion. Of the \$5.0 billion:

- Nearly \$1.6 billion represents unreserved fund balance. This is an increase from previous years due to an increase in the general fund fund balance of \$1.6 billion. The highway fund maintains a deficit of over \$791 million. The highway fund’s deficit increased by \$117 million from the prior year. The unreserved general fund balance of over \$1.7 billion offsets the highway fund deficit. Similar to last year, a \$126.9 million has been declared as a receivable in the governmental funds related to anticipated tobacco settlement proceeds in FY06.
- Governmental reserved fund balances total nearly \$3.5 billion. They include nearly \$330 million for continuing appropriations, \$305 million of spending that is yet to be identified by the legislature, over \$1.7 billion for stabilization, nearly \$29 million in bond proceeds reserved for capital projects, most of which are connected with the Boston Convention and Exhibition Center project and nearly \$364 million reserved for retirement of indebtedness, the vast majority of which is held in escrows related to crossover refunding bonds. Nearly \$132 million is reserved for the CA/T owner controlled insurance program for workers’ compensation and general liability. This reserve will be used to fund \$73 million of projected long-term claims payable with the remaining \$59 million represents amounts currently due and accumulated surplus.

To meet the fiscal challenges of fiscal 2005 and beyond, the Commonwealth took a series of measures to remain in fiscal balance.

- At the beginning of the fiscal year, \$343 million was transferred from the Stabilization Fund to pay for current expenditures. However, higher than expected tax revenues resulted in a year end inflows to the fund of \$691 million from surplus. Also in FY06, an additional 0.5% of current year net tax revenues, or \$86 million, was deposited into the Stabilization Fund. In addition, \$136 million of tax revenue withheld by control measures restricting tax growth in excess of inflation was deposited into the Stabilization Fund.
- Tobacco settlement proceeds for the year were \$257 million. All of the tobacco settlement proceeds for the year were used in support of current operations.
- Though full time equivalent employee counts grew by approximately 3% this year, employee counts are still nearly 5,500 below FY01. The graphic to the left details the changes over the last five years.

**Full Time Equivalent Workforce  
Including Higher Education  
June 2001 – June 2005**



Other changes in 2005 included:

- Continuing in FY05, the employee's share of group health insurance premiums increased from 15% to 20% of the cost of the insurance for those who earn more than \$35,000. All new employees hired after June 30, 2003 contribute 25% of the cost of the insurance, regardless of salary. However, this figure reverts to the pre-2004 figure of 15% for all employees on January 1, 2006.
- Tax decreases reducing the income tax rate from 5.3% to 5.0% were suspended in FY02 and remain frozen.
- The graduated capital gains tax portion was challenged before the Supreme Judicial Court for Suffolk County in FY04. The FY05 General Appropriation Act attempted to fix the date of the latest change in capital gains rates to January 1, 2002 and offered a remediation for taxpayers who incurred capital gains from January 1, 2002 to April 30, 2002. However, the Supreme Judicial Court found these acts unconstitutional, effectively setting the capital gains transition back to January 1, 2002. The Department of Revenue estimated that the Commonwealth will collect an additional \$150 to \$200 million in taxes under the current January 1, 2002 rate. Legislation was enacted on December 8, 2005 to rectify this issue, extending the lower tax rates to all of calendar 2002. This may result in a revenue reduction in FY06.

## OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the Commonwealth's basic financial statements. The Commonwealth's basic financial statements are composed of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information in the form of budgetary schedules, which are prepared on the statutory basis of accounting, as well as other supplementary information.

### Government-wide Financial Statements

The government-wide financial statements present the reader with a broad overview of the Commonwealth's finances in a manner similar to a private sector business. The statements include the *Statement of Net Assets*, which present the assets, liabilities and net assets for the government as a whole. Also presented is the *Statement of Activities*, which presents the functional expenses, offsetting revenues and changes in net assets of the Commonwealth. Both of the statements have separate sections for three different categories of the Commonwealth's operations. These activities are *Governmental Activities*, *Business-Type Activities* and *Discretely Presented Component Units*. Additional information is presented for college and university foundations in accordance with the implementation of Government Accounting Standards Board (GASB) Statement 39.

The government-wide financial statements can be found immediately following this discussion and analysis.

## Fund Financial Statements and Component Unit Financial Statements

*Funds* are groups of related accounts that are used to maintain control over resources that have been segregated for specific activities or objectives. The Commonwealth, like other governments, uses fund accounting to ensure and demonstrate compliance with finance related legal requirements. Within the funds, budgetary compliance is demonstrated at the appropriation level for budgeted appropriations. Fund financial statements focus on individual parts of the Commonwealth government, reporting its operations in more detail than the government-wide statements. All of the funds of the Commonwealth can be divided into three categories. It is important to realize that these fund categories use different bases of accounting and should be interpreted differently. The three categories of funds are *Governmental Funds*, *Proprietary Funds* and *Fiduciary Funds*. Further discussion on the funds can be found in the section “Financial Analysis of the Commonwealth’s Funds” and in Note 1 to the financial statements.

Component unit financial statements are presented for entities where the Commonwealth has financial accountability, but are independent of the core Commonwealth operations. They operate similar to private-sector businesses.

## Notes to the Financial Statements, Required Supplementary Information and Other Supplementary Information

The notes provide additional information that is essential to a full understanding of the financial statements as of the date provided in the government-wide and the fund financial statements. The notes to the financial statements can be found immediately following the component units’ financial statements.

## GOVERNMENT-WIDE FINANCIAL ANALYSIS

The required supplementary information section includes budgetary comparison schedules for the General and Highway Funds, along with a reconciliation comparing the original general appropriation act, all supplemental appropriations and actual budgetary spending. Variance columns are also provided. GASB Statement 41 - *Budgetary Comparison Schedule Perspective Differences*, which was effective for FY03 and forward, requires a further reconciliation schedule of the budgeted revenues and expenses to governmental fund perspective revenues and expenditures.

## Net Assets

### Major Long – Term Obligations for Assets of Political Subdivisions (amounts in millions)

Long - term assistance to authorities .....	\$	341,500
School construction grants payable.....		8,397,288
Outstanding bonds issued to fund the MBTA .....		511,546
Central Artery / Tunnel Project to be transferred to the Turnpike.....		11,275,667
Central Artery / Tunnel Project to be transferred to Massport.....		365,000
Change in unrestricted net assets due to items unique to the Commonwealth.....	\$	20,891,001

Other supplementary information is not required, but is included to present combining schedules of minor governmental funds.

Net assets may serve over time as a useful indicator of a government’s financial position. The Commonwealth’s combined net assets (governmental and business-type activities) showed a net deficit of over \$8.5 billion at the end of FY05. The *unrestricted net assets* are negative by nearly \$14.6 billion. A substantial portion of this deficit is a result of four programs where the Commonwealth decided to fund assets that it does not own. The most significant example of this is to the aforementioned Commonwealth bonding for the Central Artery / Tunnel Project (CA/T) costs. Pursuant to the Metropolitan Highway System legislation from 1997, the CA/T will transfer to the Massachusetts Turnpike Authority and to the Massachusetts Port Authority (Massport) upon completion. Portions that have not been transferred are shown as payables on the Statement of Net Assets. While the assets will be with the Turnpike Authority and Massport, (a related organization,) a

large portion of the liabilities will remain with the Commonwealth. In FY05, \$10.4 billion of the related assets to these liabilities have entered into service. The non-right of way portion of these assets is depreciating over forty years until transferred.

Another example of this type of arrangement is connected to the aforementioned MSBA. Prior to FY05, the Commonwealth declared a liability for its share of the construction costs of schools owned and operated by municipalities based on expected discounted cash flows of projects that were funded. In FY05, legislation changed the funding of school construction from a direct appropriation to a dedicated portion of the sales tax administered by the authority. This allowed a guarantee of a larger portion amount of projects, amounting to \$8.7 billion. Because of the nature of transactions between the Commonwealth and this authority, per GASB Statement 39, the authority's operations are reported within a governmental fund in this report and on the government-wide financial statements.

Two other instances where the Commonwealth incurs debt, but has no related assets relate to authorities. The first is for debt that was issued to fund an 18-month lag in operating subsidy costs, otherwise known as "forward funding," of the Massachusetts Bay Transportation Authority (MBTA) enacted in FY00. The second is the contractual assistance obligations to other authorities to help subsidize their debt service. The majority of these assistance obligations are for the Massachusetts Water Pollution Abatement Trust, the Route 3 North Transportation Improvements Association and the Massachusetts Development Finance Agency. As of June 30, 2005, the outstanding debt remaining related to the "forward funding" costs of the MBTA was approximately \$512 million, while long-term obligations for contractual assistance to other authorities was nearly \$341.5 million.

Exclusive of fiduciary assets, the Commonwealth's current cash and investments increased by over \$417 million between July 1, 2004 and June 30, 2005. This is directly due to the increased tax and charges for services revenues offset by increases in the Commonwealth's core expenses for debt service, Medicaid, other health and human services and public safety. Payments for local aid dropped in FY05 entirely due to the redirection of \$396 million in sales taxes to fund the School Modernization and Reconstruction Trust, which transfers this revenue to the MSBA. Higher education costs continue to increase. The year was also marked by a continuation of commercial paper borrowing due to the timing of current year receipts and current year major expenses such as the payment of local aid, though at a lower rate than in previous years due to improving tax revenues.

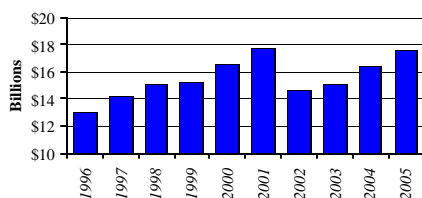
Noncurrent assets increased by over \$1.4 billion, exclusive of restricted investments. A total of nearly \$24.4 billion of the Commonwealth's net assets reflect the Commonwealth's investment in traditional capital assets such as land, buildings, infrastructure and equipment, net of accumulated depreciation. GASB Statement 34 requires the addition of the value of investment in the Commonwealth's infrastructure, including roads, bridges, beaches, dams and other immovable assets to

the face of the Commonwealth's financial statements. As these assets provide services to citizens, they are not available to finance future spending unless they are sold. Although the Commonwealth's investment in its capital assets is also reported net of related debt, it must be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities. The bulk of the Commonwealth's net assets lie in its capital assets and long – term liabilities. Current assets and liabilities are amounts that are available in the current period and obligations that will be paid within one year, respectively. The Commonwealth's current assets were nearly \$10.2 billion, while its current liabilities were nearly \$7.3 billion. Restricted net assets represent resources that are subject to external constraints on resources. The tables below portray the Commonwealth's net assets and the changes to those net assets for the fiscal year. In addition, due to the implementation of GASB Statement No. 39 in FY04 net assets of higher education foundations have been included as part of the business – type activities.

**Net Assets as of June 30, 2005 and 2004**  
(in millions of dollars)

	Governmental Activities		Business - Type Activities		Total Primary Government	
	June 30, 2005	June 30, 2004	June 30, 2005	June 30, 2004	June 30, 2005	June 30, 2004
Current and other non-capital assets...	\$ 10,905	\$ 8,976	\$ 3,022	\$ 2,543	\$ 13,927	\$ 11,519
Capital assets.....	22,220	21,774	2,174	1,691	24,394	23,464
<b>Total Assets .....</b>	<b>33,125</b>	<b>30,750</b>	<b>5,196</b>	<b>4,234</b>	<b>38,321</b>	<b>34,983</b>
Long term liabilities.....	37,914	32,071	1,616	1,205	39,530	33,276
Other Liabilities.....	6,755	5,020	537	547	7,292	5,567
<b>Total Liabilities .....</b>	<b>44,669</b>	<b>37,091</b>	<b>2,153</b>	<b>1,752</b>	<b>46,822</b>	<b>38,843</b>
Net assets:						
Invested in capital assets, net of related debt.....	197	2,033	1,149	1,133	1,346	3,166
Restricted.....	3,419	3,349	1,331	916	4,750	4,265
Unrestricted.....	(15,160)	(11,723)	563	433	(14,597)	(11,290)
<b>Total Net Assets (deficits) ....</b>	<b>\$ (11,544)</b>	<b>\$ (6,341)</b>	<b>\$ 3,043</b>	<b>\$ 2,481</b>	<b>\$ (8,501)</b>	<b>\$ (3,860)</b>

**Changes in Net Assets**  
**Revenue from Taxation –**  
**GAAP Basis 1996-2005**



The Commonwealth's net assets decreased by over \$4.6 billion between FY04 and FY05, almost entirely due to the restructuring of the school construction program. Revenues in general increased, led by tax revenue increases of \$1.2 billion. Grants and contributions decreased by nearly \$719 million, led by less draws for unemployment compensation by nearly \$569 million and a \$141 million drop in capital grants, due to near completion of the Central Artery / Tunnel Project. The tax revenue increase is attributable in large part to increases of \$838 million in income tax payments and \$153 million in sales and use tax collections. Corporate tax collections improved by \$147 million. The Department of Revenue has also implemented sophisticated "data mining" software, which seeks out non-filer data from a multitude of sources.

This has increased the amount that has been declared as receivable on the Statement of Net Assets, but also has increased an offsetting allowance for doubtful accounts, as many of these non-filers may be cash-based businesses or are already in financial difficulty.

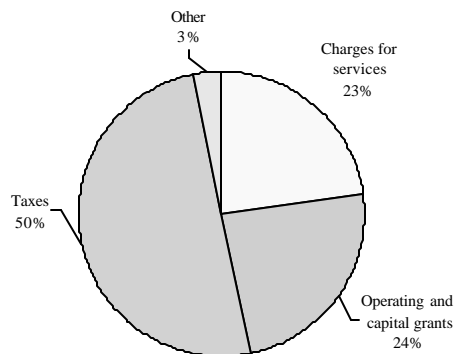
Total charges for services also increased by nearly \$862 million due to a nearly \$278 million increase in unemployment collections and a \$283 million increase in charges related to higher education. Approximately 44% of the Commonwealth's total revenue came from taxes, while the remainder resulted from programmatic revenues, including charges for services and grants and contributions, the bulk of which is federal aid. Increases also occurred in restricted net assets amounting to \$487 million largely due to an additional crossover refunding of debt and additional amounts set aside for stabilization. This is coupled with decreased spending in the Unemployment Compensation Fund, but slight increases to Higher Education. However, Medicaid spending continued to increase as did other Health and Human Services largely connected to the continual skyrocketing medical costs. Other programmatic expenses remained largely unchanged or dropped due to tighter budget controls.

The Commonwealth's revenues are presented in the table and graphics that follow.

***Changes in Net Assets during the Fiscal Years Ended June 30, 2005 and 2004***  
***(in millions of dollars except percentages)***

	Governmental Activities		Business - Type Activities		Total Primary Government		Total Primary Government		
	June 30, 2005	June 30, 2004	June 30, 2005	June 30, 2004	June 30, 2005	June 30, 2004	June 30, 2005	June 30, 2004	% Change
							Percentage	Percentage	% Change
<b>Revenues</b>									
Program Revenues:									
Charges for services.....	\$ 8,040	\$ 7,740	\$ 3,254	\$ 2,692	\$ 11,294	\$ 10,432	29%	27%	1%
Operating grants and contributions....	7,962	8,017	855	1,377	8,817	9,394	22%	25%	-2%
Capital grants and contributions.....	461	602	-	-	461	602	1%	2%	0%
General Revenues:									
Taxes.....	17,580	16,407	-	-	17,580	16,407	44%	43%	1%
Other.....	1,168	1,043	229	182	1,397	1,224	4%	3%	0%
<b>Total Revenues.....</b>	<b>35,211</b>	<b>33,808</b>	<b>4,338</b>	<b>4,251</b>	<b>39,549</b>	<b>38,059</b>	<b>100%</b>	<b>100%</b>	<b>0%</b>
<b>Expenses</b>									
Medicaid.....	7,706	6,909	-	-	7,706	6,909	17%	19%	-2%
Direct local aid.....	4,526	4,877	-	-	4,526	4,877	10%	13%	-3%
Other health and human services.....	5,197	4,829	-	-	5,197	4,829	12%	13%	-2%
Lottery.....	3,692	3,607	-	-	3,692	3,607	8%	10%	-2%
Higher education.....	4,162	-	3,040	2,579	7,202	2,579	16%	7%	9%
Primary and secondary education.....	4,058	1,211	-	-	4,058	1,211	9%	3%	6%
Unemployment compensation.....	-	-	1,663	2,461	1,663	2,461	4%	7%	-3%
Other.....	10,147	9,781	-	-	10,147	9,781	24%	27%	-3%
<b>Total Expenses.....</b>	<b>39,488</b>	<b>31,214</b>	<b>4,703</b>	<b>5,040</b>	<b>44,189</b>	<b>36,254</b>	<b>100%</b>	<b>100%</b>	<b>6%</b>
<b>Excess / (Deficiency)</b>									
<b>before transfers.....</b>	<b>(4,277)</b>	<b>2,594</b>	<b>(365)</b>	<b>(789)</b>	<b>(4,641)</b>	<b>1,805</b>			
Transfers.....	(927)	(830)	927	830	-	-			
Change in Net assets (deficits).....	(5,203)	1,763	562	41	(4,642)	1,804			
Net assets - beginning .....	(6,341)	(8,105)	2,482	2,441	(3,860)	(5,664)			
Net assets - ending.....									
<b>Total Net Assets (deficits) .....</b>	<b>\$ (11,544)</b>	<b>\$ (6,341)</b>	<b>\$ 3,043</b>	<b>\$ 2,482</b>	<b>\$ (8,501)</b>	<b>\$ (3,860)</b>			

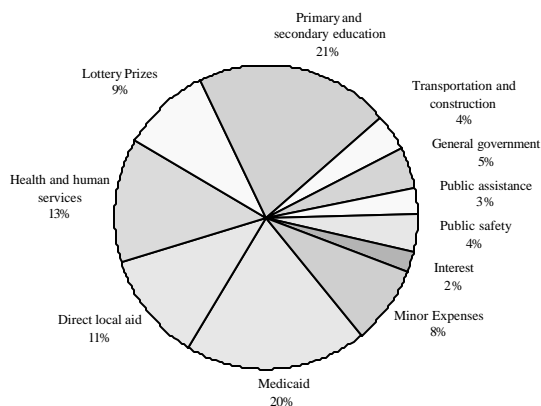
**Revenue–Governmental Activities**  
Fiscal Year Ending June 30, 2005



The largest category of tax revenue is income taxes. Of the nearly \$17.6 billion in tax revenue within governmental activities, \$10.0 billion was from income taxation, \$3.9 billion from sales, \$1.1 billion from corporations, \$687 million from motor fuels and over \$1.8 billion from other forms of taxation. The largest operating grants are the federal Medicaid subsidies.

The largest capital grants are for transportation, namely grants for highway construction. Finally, Lottery revenues encompass approximately 59% of the Commonwealth's charges for services. Lottery revenues increased this year by approximately \$96 million, largely due to increases in scratch ticket sales and new ticket sales from the new online game Cash Winfall, which commenced during the fiscal year. Starting in FY06, legislation directs that the ceiling on lottery revenues that are to be distributed to municipalities will be gradually removed by FY09.

**Major Expenses–Governmental Activities**  
Fiscal Year Ending June 30, 2005

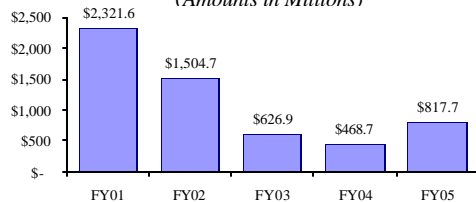


Medicaid represents 20% of all the Commonwealth's governmental expenses. However, it must be noted that approximately half of the Medicaid expenses are subsidized in the form of federal reimbursements. These subsidies are noted below in the "charges for services" segment. The largest expense that is not subsidized by program revenues is direct local aid to the municipalities of the Commonwealth. According to the Department of Revenue, Division of Local Services, inclusive of regional school aid, nearly 77% of these funds are earmarked for public education or related activities. Below is a chart that summarizes governmental expenses of the Commonwealth.

Business – type activities are functions that equate to activities of a private enterprise. In the Commonwealth the institutions of higher education are deemed to be business type activities because of their lack of separate taxation. Also, unemployment compensation is considered to be a business – type activity.

**Business–Type Activities**

**Unemployment Compensation Fund**  
**Net Assets**  
Fiscal Year Ending June 30, 2005  
(Amounts in Millions)



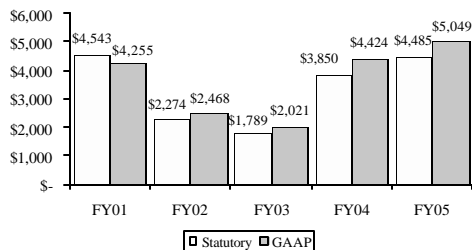
The business-type activities increased the Commonwealth's net assets by nearly \$561 million. This primarily resulted from a \$349 million increase in the Commonwealth's Unemployment Compensation Fund net assets due to the improving economy and a 19% increase in contributions. Net assets of the schools of higher education, increased by \$212 million largely due to increases in net tuition and fee revenue (by over 8%) and in ancillary revenues (by nearly 40%).



## FINANCIAL ANALYSIS OF THE COMMONWEALTH'S FUNDS

### Governmental Funds

**Governmental Fund Balance**  
**Statutory vs. GAAP**  
(Amounts in Millions)



As noted earlier, the Commonwealth uses fund accounting to demonstrate interperiod equity and the extent to which current resources are financing the full cost of services that citizens are receiving.

Governmental funds account for the near term inflows, outflows and balances of expendable resources of the Commonwealth's core functions and services. Each major fund is presented in a separate column in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures and changes in fund balances. In FY05, because of the nature of the relationship between the Commonwealth and the MSBA, the MSBA's operations and results thereon are presented as a fund in the governmental fund statements, though it is a legally separate authority. The basic governmental funds financial statements can be found immediately following the government-wide financial statements.

The Commonwealth develops its budgets on a statutory basis. A comprehensive process is conducted with all departments to convert the statutory basis reporting to generally accepted accounting principles. System generated reports from the state accounting system and data warehouses are combined with reports from each of the Commonwealth departments to record governmental fund perspective, departmental accruals. Similar reports are generated to show budgetary control, which is maintained at the appropriation level, not at the fund level. There are four major items which account for almost all the difference between the statutory basis reporting and the governmental fund perspective: accruals for the Medicaid program, compensated absences, claims and judgments and tax revenue accruals. From the governmental fund perspective, additional major adjustments are necessary to present the government wide statements, largely for debt and fixed assets activity.

### Governmental Fund Operations - GAAP Basis - Fund Perspective (Amounts in millions)

	FY01	FY02	FY03	FY04	FY05
Beginning fund balances .....	\$2,826.1	\$4,255.4	\$2,467.9	\$2,021.0	\$4,424.4
Restatement due to implementation of GASB 34	-	551.2	-	-	-
Revenues and other financing sources.....	39,256.4	36,476.6	42,798.0	44,371.7	43,532.6
Expenditures and other financing sources.....	37,827.1	38,815.3	43,244.9	41,968.3	42,908.4
Excess / (deficiency).....	1,429.3	(1,787.5)	(446.9)	2,403.4	624.2
Ending fund balances .....	<u>\$4,255.4</u>	<u>\$2,467.9</u>	<u>\$2,021.0</u>	<u>\$4,424.4</u>	<u>\$5,048.6</u>

The drop in revenues and expenditures in FY05 from FY04 is attributable to a \$2.6 billion drop in new and refunding bond sources from FY04 due to increased interest rates, which lessen refunding opportunities.

As of the end of fiscal 2005, the Commonwealth's governmental funds reported combined ending fund balances of over \$5.0 billion, an increase of over \$624 million from the previous year. However, of the \$5.0 billion, the following amounts are reserved or committed:

**Governmental Funds - Reserves of Fund Balances**

(Amounts in millions)

	<u>2005</u>	<u>2004</u>	<u>Change</u>	<u>Percentage Change</u>
Continuing appropriations .....	\$ 329.6	\$ 638.5	\$ (309.0)	-48%
Transitional escrow .....	304.8	-	304.8	100%
Commonwealth stabilization .....	1,729.1	1,137.3	591.7	52%
Retirement of indebtedness .....	967.7	761.3	206.4	27%
Capital projects .....	29.0	734.7	(705.8)	-96%
Central artery				
Workers Compensation and				
General liability insurance reserve..	132.2	159.0	(26.8)	-17%
<b>Total reserved balances .....</b>	<b>3,492.3</b>	<b>3,430.9</b>	<b>61.4</b>	<b>2%</b>
Unreserved:				
General Fund.....	1,730.3	1,014.5	715.8	71%
Special revenue funds.....	329.3	587.0	(257.7)	-44%
Capital projects funds.....	(503.3)	(607.9)	104.6	-17%
Debt service fund.....	-	-	-	0%
<b>Total unreserved balances .....</b>	<b>1,556.3</b>	<b>993.5</b>	<b>562.8</b>	<b>57%</b>
<b>Total fund balances .....</b>	<b>\$ 5,048.6</b>	<b>\$ 4,424.4</b>	<b>\$ 624.2</b>	<b>14%</b>

The change in unreserved was nearly \$563 million, due largely to the healthy excess of revenues over expenditures noted above, offset by the increase in school construction grants. During FY05 over \$343 million was used from the stabilization fund to balance the budget. These draws were offset by contributions to the stabilization fund in the amount of over \$934 million.

The amounts reserved for retirement of indebtedness entirely represent escrows for crossover refunding bonds and payments held in escrow for grant anticipation notes to be paid in FY06. The reserve for Central Artery workers' compensation and general liability represents the balance of funds earmarked for claims in an owner controlled insurance program. The reserve will continue to decline as claims arise during the windup of the project.

During FY05 the general and highway funds were the primary operating funds of the Commonwealth. At the end of the current fiscal year, the fund balance of the general fund was over \$4.1 billion. Of this amount, over \$1.7 billion was apportioned to the Commonwealth's Stabilization Fund. An additional \$305 million was reserved in a transitional escrow to be either spent in FY06 or returned to the General Fund. Nearly \$303 million was also reserved for continuing appropriations to liquidate contracts and purchase orders from the prior fiscal year in the general fund.

Presented in the governmental funds are the balances and results of operations from the MSBA. In its initial year of operations, the MSBA received \$396 million of dedicated sales tax revenues and \$565 million in Commonwealth general obligation bond proceeds. Nearly all of

these revenues and the initial funding from FY04 of \$150 million were used for to fund school construction in municipalities during FY05 and for previous years with an additional \$1.5 million in expenditures of the MSBA used for administrative and “start up” costs.

### **Proprietary Funds**

Proprietary Funds report activities of the Commonwealth that are structured similar to for profit businesses. Proprietary fund financial statements provide the same type of information as the government – wide financial statements, only in greater detail.

As discussed in the business – type activities above, the business type activities increased the Commonwealth’s net assets by nearly \$561 million.

### **BUDGETARY HIGHLIGHTS**

Differences between the original budget and final budget expenditures amount to nearly \$355 million, exclusive of transfers. As revenues continued to increase this fiscal year, supplemental budget legislation grew. The supplemental budgets are summarized as follows:

- ◆ An initial supplemental operating budget of nearly \$121 million, inclusive of \$32 million in collective bargaining agreements for higher education employees, \$34 million for costs associated with snow and ice removal, \$12 million for private counsel compensation for public defenders and \$43 million for a variety of other programs and services.
- ◆ A second supplemental operating budget including an additional \$41 million for snow and ice removal, \$21 million for health insurance premium costs and \$9 million for substance abuse treatment to ensure the receipt of \$15 million in federal funds from the substance abuse block grant. The legislation also included \$8 million for a variety of programs and services.
- ◆ \$25 million in a special budget to fund the relief effort at Camp Edwards on the Otis Air National Guard Base for the victims of Hurricane Katrina.
- ◆ A final supplemental budget for over \$129 million including \$72 million in additional collective bargaining agreement funding, \$6 million to fund workers compensation and utility costs for the Department of Corrections, \$24 million to cover a shortfall in the uncompensated care pool and the remainder for a large number of programs and services.

The original budget was passed on June 25, 2004, just before the start of FY05. Transfers of revenues and expenditures largely related to stabilization activity and taxation transfers resulted in nearly \$2 billion of additional financial uses, net.

### **CAPITAL ASSET AND DEBT ADMINISTRATION**

#### **Capital Assets**

Capital assets of the Commonwealth include land, buildings, improvements, equipment, vehicles and infrastructure. The Commonwealth’s investment in capital assets for its governmental and business-type activities as of June 30, 2005, amounts to \$33.8 billion, net of accumulated depreciation of \$9.4 billion, leaving a net book value of \$24.4 billion. Infrastructure includes assets that are normally immovable and of value only to the Commonwealth, such as

roads, bridges, beaches, piers and dams. Of the investment in capital assets noted above though, \$11.2 billion of this amount includes assets that will transfer to the Turnpike Authority and the Massachusetts Port Authority upon completion of the Central Artery / Tunnel project that are in use and depreciating or are right of way. This is in addition to \$1.7 billion already transferred to these Authorities.

The total increase in the Commonwealth's investment in capital assets , net of disposals and changes in accumulated depreciation from 2004 to 2005 was nearly \$929 million, including increases to construction of the CA/T. Additional information on the Commonwealth's capital assets can be found in the notes to the financial statements.

The following table details the capital asset activity for the Commonwealth. Similar to previous charts, FY04 amounts for business-type activities include amounts for the foundations established on behalf of the schools of higher education.

#### Changes in Capital Assets

(net of depreciation - amounts in thousands)

	Governmental Activities		Business - type Activities		Total	
	2005	2004	2005	2004	2005	2004
Land, including Central Artery .....	\$ 1,166,762	\$ 1,127,714	\$ 62,033	\$ 59,361	\$ 1,228,795	\$ 1,187,075
Historical treasures .....	-	-	729	703	729	703
Construction in process .....	1,311,728	1,023,815	449,722	136,233	1,761,450	1,160,048
Construction in process - Central Artery / Tunnel Project .....	350,247	1,244,463	-	-	350,247	1,244,463
Buildings .....	1,943,684	1,982,991	1,285,709	1,128,039	3,229,393	3,111,030
Machinery and equipment .....	241,029	120,869	270,847	260,741	511,876	381,610
Infrastructure, including Central Artery ...	17,206,074	16,273,667	-	-	17,206,074	16,273,667
Library collections .....	-	-	105,021	105,590	105,021	105,590
<b>Total .....</b>	<b>\$ 22,219,524</b>	<b>\$ 21,773,519</b>	<b>\$ 2,174,061</b>	<b>\$ 1,690,667</b>	<b>\$ 24,393,585</b>	<b>\$ 23,464,186</b>

#### Debt Administration

The Commonwealth issues short-term and long-term debt. Debt that is general obligation in nature is backed by the full faith and credit of the Commonwealth and paid from governmental funds. Additionally, short-term notes are issued and redeemed annually.

The Commonwealth issued nearly \$2.7 billion in debt this year. Of this amount, nearly \$1.4 billion was used to fund ongoing projects and nearly \$1.3 billion was in the form of general and special obligation refunding bonds, taking advantage of low interest rates. Of the \$1.4 billion in new issuances, \$500 million was used to fund school construction through the MSBA. An additional \$227 million was generated through a second special obligation crossover refunding transaction. Though this is a legal defeasance of debt, because of the nature of the transaction and the use of its proceeds, an accounting defeasance is not accomplished. Subsequent to year-end, the Commonwealth completed three additional bond transactions, with a \$60 million portion of the third transaction sold as a taxable transaction.

Though the majority of bond sales this year were for transportation related expenditures and the aforementioned school construction, for governmental purposes, the ongoing projects bond sales also included debt issuances in excess of \$50 million for:

- ◆ \$93.7 million for the rehabilitation of the Suffolk County Courthouse.
- ◆ Nearly \$121.9 million for preservation and improvement of environmental assets, including parks.

During FY05 over \$882 million in bond principal was repaid. Additional information on the Commonwealth's short and long-term debt obligations can be found in the notes to the financial statements.

Below is a table, which details the Commonwealth's debt by type for the fiscal year compared to the prior fiscal year.

**Changes in Long - Term Debt Obligations**  
(net of related premiums and discounts - amounts in thousands)

	Governmental Activities		Business - type Activities		Total	
	2005	2004	2005	2004	2005	2004
General obligation bonds ....	\$ 14,501,086	\$ 14,142,886	\$ -	\$ -	\$ 14,501,086	\$ 14,142,886
Special obligation bonds .....	1,448,373	1,331,946	-	-	1,448,373	1,331,946
Revenue obligation bonds ..	-	-	1,421,557	1,049,095	1,421,557	1,049,095
Grant anticipation notes .....	<u>1,907,340</u>	<u>1,907,340</u>	<u>-</u>	<u>-</u>	<u>1,907,340</u>	<u>1,907,340</u>
<b>Total .....</b>	<b>\$ 17,856,799</b>	<b>\$ 17,382,172</b>	<b>\$ 1,421,557</b>	<b>\$ 1,049,095</b>	<b>\$ 19,278,356</b>	<b>\$ 18,431,267</b>

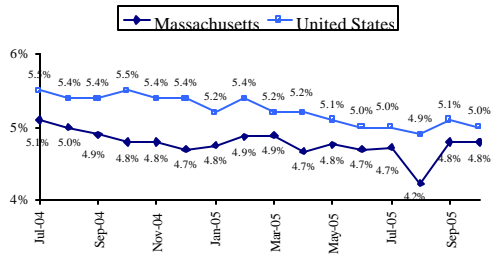
**ECONOMIC FACTORS AND NEXT  
YEAR'S BUDGETS AND RATES**

Massachusetts continues to recover economically. Our Commonwealth is home to many world-renowned institutions of medicine and higher education, both public and private, keeping the economy relatively stable and an incubator for new ideas and growth. Unemployment has dropped due to this stabilization.

The Commonwealth with an international reputation for medical, cultural, historical and educational institutions remains the economic and educational hub of New England. The Commonwealth's economy remains diversified, but its strongest component is its knowledge – based technology and service industries. The Commonwealth is home to 16 S&P 500 companies, among them eight *Fortune 500* headquarters.

Massachusetts' infrastructure provides strong support for this knowledge-based economy. There are over 120 colleges and universities located in Massachusetts, and the 2000 US Census, updated in March of 2005, estimated that 36.7% of the residents over age 25 have earned bachelor's degrees, compared to an estimate of 28% for the United States as a whole. Excluding Washington DC, Massachusetts is first in the nation in educational attainment by age 25. In the same survey, nearly 87% of residents over age 25 at least have a high school diploma.

### Monthly Unemployment Rate July 2004 – October 2005



### REQUESTS FOR INFORMATION

Inflation continued to rise though in the past year. The Boston consumer price index rose nearly 4% from July 2004 to July 2005. However, fuel and utilities prices rose nearly 16% and transportation 6%. Extended to September 2005 to include the oil price shock from Hurricane Katrina, inflation was 8.4% with a huge 34% jump in fuel and utilities prices and a nearly 24% rise in other transportation prices. Though the oil price shock seems to be abating, it will effect budgeting decisions throughout FY06.

Per capita net income continues to rise in the Commonwealth faster than inflation. Per capita net income rose 5.3% in FY05, though lagging behind the 6.5% rise nationally. However, on a dollar basis, per capita net income is over \$9,200 higher than the national average.

Unemployment declined throughout the year, but spiked in September of 2005, due to Katrina. Preliminary figures indicate that the downward trend is resuming in October. The unemployment rate in the Commonwealth stood at 4.8% in October. This figure is down from a high of 5.1% early last year. The Commonwealth is still below the national rate of 5.0%.

This financial report is designed to provide a general overview of the Commonwealth's finances for all of the Commonwealth's citizens, taxpayers, customers, investors and creditors. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Commonwealth of Massachusetts, Office of the State Comptroller, 1 Ashburton Place, 9<sup>th</sup> Floor, Boston, Massachusetts, 02108. You may also download this report at: <http://www.mass.gov/osc/reports/reports.htm>.